

PRACTICAL INFORMATION



HERMES COVER SPECIAL NOVEMBER 2008

Counter-guarantees

EXPORT CREDIT GUARANTEES OF THE
FEDERAL REPUBLIC OF GERMANY

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In order to have a chance of successfully bidding for contracts in tenders or carrying out orders, exporters often need to put up contract bonds in favour of their foreign buyers. This type of bond is traditionally issued by banks or guarantee insurers. Since these institutes only “lend” their creditworthiness to the exporters, as it were, and intend to take recourse to the exporter for the amount they have to pay out in the event that the bond is called, they insist on adequate creditworthiness of the exporter as a prerequisite before they are prepared to issue a bond. With the counter-guarantee, the Federal Government participates in the guarantor’s risk of unsuccessful recourse, thus increasing his readiness to meet the demand which exists from exporters for bonds. At the same time, the government helps in this way to improve exporters’ liquidity.

I. BACKGROUND

Before the counter-guarantee was introduced, only the risks involved in bonds with the foreign buyer as beneficiary were insurable under Federal Government cover by means of a contract bond guarantee. This protects the exporter to the extent that the Federal Government indemnifies 95% of the sum when a bond is called unfairly or for political reasons and the guarantor takes recourse in his turn to the exporter demanding compensation for the amount paid out. This is in fact primarily intended to protect the exporter and correspondingly only covers cases where the exporter himself bears no responsibility for the calling of the bond. It does not insure against the exporter’s own failings. Contract bond cover therefore disregards the bond issuer’s risk that, if the bond is called, the exporter may not be able to satisfy the claim he then has for compensation. If the exporter assigns the potential right to payment out of the guarantee to him, the guarantor can also benefit from the contract bond guarantee but only for the risks mentioned above and above all not for the risk that in the normal situation would condemn his taking recourse on the exporter to failure – fair calling of the bond for legitimate commercial reasons which lie within the responsibility of the exporter, in other words, when the exporter has himself caused the calling of the bond.

The Federal Government counter-guarantee provides a solution to this problem. Under certain circumstances, the Federal Government is prepared to assume on behalf of the guarantor the major part – up to 80% – of the risk of unsuccessful recourse on the exporter. The banks, in particular, classify this as a credit risk (since a bond is a type of credit). They therefore charge it against the exporter’s credit lines in the same way as they would a



financial loan, demand security – e.g. in the form of cash collateral – and may in some cases refuse to issue a bond at all when the credit lines are bumping against their limit. A Federal Government counter-guarantee relieves this situation: existing credit lines are either not put under additional strain or will be increased by the amount covered under the counter-guarantee and can be used for financial loans where needed. Collateral security can be dispensed with, and may be freed up for other purposes. If credit lines are exhausted, the option of issuing badly needed bonds is opened up again. In this way the counter-guarantee creates flexibility through greater liquidity and can benefit small and medium enterprises in particular, which in the nature of things have fixed credit lines which are smaller.

The counter-guarantee is a non-operative and unrestricted assumption of risk. In the external relationship with the beneficiary the Federal Government lets the guarantor act alone and leaves the entire administration of the bond with the beneficiary to him. It undertakes to reimburse the guarantor under all circumstances and immediately for the agreed percentage of the amount paid out due to the calling of the bond. The Federal Government does not charge any premium of its own for this risk-sharing. Instead, after deduction of a share for the guarantor's administrative efforts, it asks a pro rata share in the bond premium paid by the exporter to the guarantor equivalent to the agreed percentage to be indemnified under the counter-guarantee. This means that the counter-guarantee generates no extra cost for the exporter.

II. LEGAL CONSTRUCTION

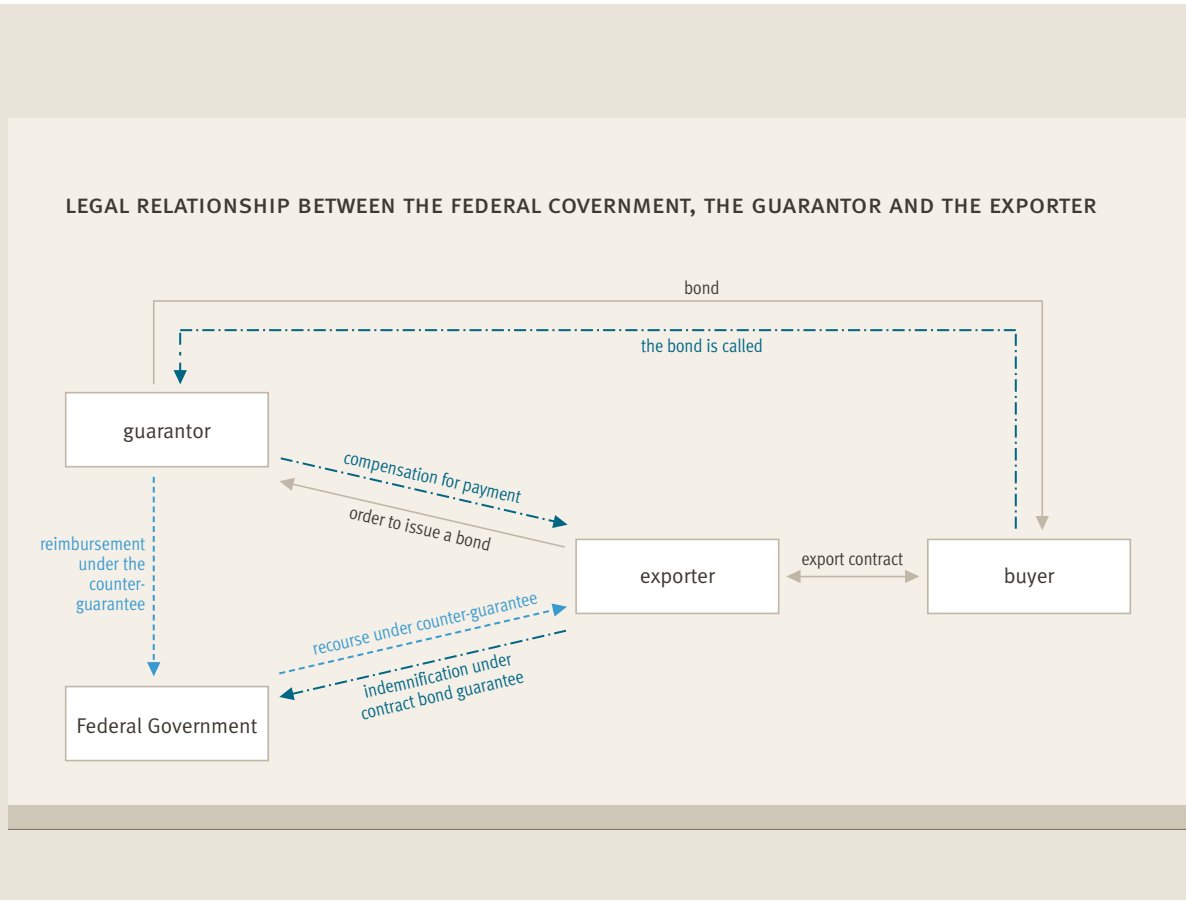
In terms of legal construction, the relationship between the Federal Government and the guarantor on the one hand must be distinguished here from that between it and the exporter (the policyholder) on the other. These two legal relationships are regulated under the provisions of the Federal Government's policy with the exporter:

Under the counter-guarantee rooted in the exporter's policy from the Federal Government, the guarantor has a direct claim on the Government, itself equivalent to a guarantee, for the pro rata reimbursement of the bond amount called (i.e., it is a contract in favour of a third party). The guarantor has no real obligations of his own under the exporter's policy. It is nevertheless in his own interest to fulfil certain conditions, in order to put the counter-guarantee into effect. These include the signing of a Letter of Undertaking - Counter-Guarantee (see IV. 7. below). It is in this Letter of Undertaking that the obligations of the guarantor are described.

As soon as the Federal Government has met its obligation to reimburse the guarantor due to his paying a bond call as described above, a claim in its favour for recourse on the exporter is created. Since a counter-guarantee is only assumed in combination with a contract bond guarantee, there may potentially be an opposite claim from the exporter (and policyholder) for indemnification under the contract bond guarantee. The fact that there is both a claim and a counterclaim which might be "set off" against each other leads to a delay in the recourse action undertaken by the Federal Government.

This structure is clear from the diagram on the next page.

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**III. PREREQUISITES FOR GRANTING
A COUNTER-GUARANTEE**

1. GENERAL REQUIREMENTS

Counter-guarantees can be assumed in principle for all export transactions which meet the general requirements for Federal Government export credit guarantees. Consequently, a counter-guarantee cannot be granted when the country and payment terms of a transaction place it in the category of so-called marketable risks.



Counter-guarantees are available for all types of contract bonds which are also eligible for contract bond cover: bid, advance payment, supply and performance and maintenance bonds, for limited and unlimited validity periods and for direct and indirect bonds.

Risk sharing of more than 80% by the Federal Government is not permissible, whereas there is no problem in agreeing any percentage below this. The percentage is only in respect of the nominal bond amount and does not apply to other items receivable such as interest, compensation for damages or costs. The sole exception to this rule is advance payment bonds: if these include interest calculated on the amount paid in advance, this may also be covered by the counter-guarantee.

A counter-guarantee can only be granted together with a contract bond guarantee, since otherwise there would be no balancing of a claim against a counterclaim for indemnification by the exporter, and this is the material justification for the Federal Government's deferred recourse on the exporter. To this extent all the prerequisites for granting contract bond cover also apply to the counter-guarantee. Under normal circumstances this means that – with the exception of bid bonds – it is necessary to have a principal guarantee for supplier credit cover in parallel, unless the terms of payment for the export receivables involved mean that there is no insurable risk. The cases where risks are not eligible for cover within this meaning are by no means limited to the classical case of a resident person's or institution's liability in the form of a letter of credit confirmed by a German bank but meanwhile include quite a number of other constellations. If supplier credit cover has been applied for but the approval procedure has not yet been completed, this prevents on principle also the granting of a contract bond guarantee and a counter-guarantee. Exceptions may only be made if there are exceptional circumstances in individual cases.

In the case of advance payment bonds, too, a parallel contract bond guarantee is necessary for the additional granting of a counter-guarantee. The usual practice of covering such advance payment bonds not by a contract bond guarantee with them as its object, but by not deducting the advance payment received under manufacturing risk cover from the prime costs covered is thus not possible (see V. 2. below).

2. THE APPLICATION AND HOW IT IS CHECKED

The exporter must apply for a counter-guarantee by filling in a separate form. The application should normally be made at the same time as cover for the export transaction is applied for (manufacturing risk and/or supplier credit cover as well as a contract bond guarantee). It can however be made later for transactions which have already received these types of cover. Bond credit facilities which were exhausted by earlier transactions can be freed up in this way for new business, which may not in fact even be intended for Federal Government cover. This affords a certain flexibility to the exporter and mitigates the effects of the rigid link between contract bond cover and a counter-guarantee.

The exporter must submit details of his company, his financial situation, the bond volume and the technical standard of the goods underlying the transaction together with the completed application form. The check to assess whether the risk is acceptable is done independently of the guarantor's own assessment. It is based mainly on the details given by the exporter himself and covers possible calling of the bond both for commercial and technical reasons (financial strength and performance).

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The maximum limit for assuming counter-guarantees is an amount of 80 million EUR per exporter, which may be spread over one or more counter-guarantees. The reference amount here is the percentage of the bond amount guaranteed by the Federal Government. The maximum commitment of 80 million EUR is an absolute maximum, which may be set for individual exporters at a lower level from case to case depending on the risk estimated.

3. ELIGIBLE GUARANTORS

German banks or German guarantee insurers and (subject to certain conditions) also foreign banks qualify as guarantors. This means that the beneficiary of a counter-guarantee can be a bank or guarantee insurer constituted according to German Law with its head office in Germany or a foreign bank or insurer with a registered branch office in Germany if the contract bond in question has been issued by the German branch. Since February 2011 also foreign banks which fulfil the criteria of eligibility for a buyer credit guarantee may act as guarantors and make use of the advantages of a counter-guarantee.

IV. THE LEGAL RELATIONSHIP BETWEEN THE FEDERAL GOVERNMENT AND THE GUARANTOR**1. THE GUARANTOR'S RIGHTS UNDER THE COUNTER-GUARANTEE**

The guarantor's right to payment out of the counter-guarantee is rooted in the Federal Government's policy with the exporter as policyholder, and is explicitly notified to the guarantor in a separate letter which is sent to him (so-called confirmation letter).

The claim to payment out of a counter-guarantee which has both become effective and remains in effect is triggered when the contract bond – for whatever reason – is duly called by the buyer (the beneficiary of the contract bond). The amount to be paid is determined by the percentage actually guaranteed and set out in the policy and the confirmation letter. There is no self-retention beyond the percentage retained by the guarantor. The claim is paid out in the currency stipulated by the policy within ten bank days of receiving the written demand together with a declaration and evidence that payment has been effected to the beneficiary of the contract bond in response to a formally correct calling of the bond. This effectively amounts to an unconditional undertaking by the Federal Government to pay the guarantor on first written demand.

2. THE SHARE OF THE FEDERAL GOVERNMENT IN THE BOND PREMIUM

A counter-guarantee can only be assumed if the guarantor declares his readiness to allow the Federal Government to take a share in the bond premium payable to him. Since the guarantor bears alone the entire burden of administering the bond towards the beneficiary, he is entitled to retain 10% of the calculated bond premium as a fronting fee. The remaining 90% is then shared



between guarantor and Federal Government pro rata in the same proportion as the agreed percentages under the counter-guarantee.

In principle the Federal Government will accept the premium calculated by the guarantor. The guarantor is however required to sign a formal Letter of Undertaking under the counter-guarantee that he will charge a bond premium at market rates. This means the premium he would charge if there were no sharing of the risk with the Federal Government. The relevant basis for fixing the premium to be shared is the amount which is charged on the nominal bond amount (in the case of advance payment bonds this is plus interest, if included). The guarantor must deliver a copy of the invoice he sends to the exporter to the Federal Government. If guarantor and beneficiary of the counter-guarantee are not identical (e.g. a back-to-back guarantee from the exporter's principal bank for a contract bond issued by a state bank (Landesbank) or third party bank), the share in the bond premium to which the beneficiary (exporter's principal bank) is entitled shall be the basis for the calculation. In this case the beneficiary has to deliver a copy of the guarantor's invoice. The share due to the Federal Government must be paid in the same currency in which the exporter is invoiced.

Since bond premiums are generally invoiced, depending on the validity of the bond, as an annual premium, there may be subsequent premium payments over and above the initial one. The rules for dividing the respective shares apply similarly to these.

3. EFFECTIVENESS OF THE COUNTER-GUARANTEE

The Federal Government's obligation to pay under a counter-guarantee depends on the simple fact of the contract bond being called, irrespective of the reason for it, and paid by the guarantor. When the counter-guarantee has "gone live", the government therefore wants

to know at the earliest possible first of all whether it has a clear obligation to pay and secondly it wants to have received its share of the bond premium. In view of the construction of the counter-guarantee, which amounts to an unconditional demand guarantee, the Federal Government would not be able to assert any defences against a legitimate claim for reimbursement invoking a possible non-payment of its share in the bond premium. This explains why a counter-guarantee which has already been given only becomes effective when four conditions have been fulfilled. These key aspects in rendering the counter-guarantee effective are all in the hands of the guarantor.

The counter-guarantee becomes effective when:

- ▶ The contract bond has been issued by the guarantor
- ▶ The issuance of the contract bond has been notified to the Federal Government within 20 bank days of issuance on a special form ("Notification of the issuance of a contract bond and announcement of the payment of bond commission")
- ▶ The Federal Government's share of the bond premium has been paid in full within 20 bank days of notification of issuance of the contract bond and
- ▶ The guarantor submits a legally binding Letter of Undertaking – Counter-guarantee at the latest together with the notification of the issuance of the bond.

The periods mentioned above are substantive periods of preclusion. If they are not observed, the counter-guarantee will without fail not become effective. No remedy for this delay is possible. In order to make the situation perfectly clear, a written declaration is sent to the guarantor and the policyholder in cases where the counter-guarantee fails to become effective as a result of such dilatory failure to observe these deadlines.

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Non-payment or late payment of the initial premium has no effect other than the failure of the counter-guarantee to become effective.

Once the counter-guarantee has become effective following the payment of the first premium, it will lose this status only if the Federal Government's share in any follow-on premium payable by the policyholder (exporter) in the course of any one calendar year is not paid by the end of the respective calendar year at the latest. The Federal Government may refrain from invoking the invalidity judging on the circumstances of the individual case, in particular taking into account the reasons for the failure to pay within the time limit and the duration of the delay as well as the risk incurred during the delay.

These deadlines are based on the sequence of events deemed to be typical – i.e. that contract bonds will only be issued when the counter-guarantee has been assumed by the Federal Government and the notification to this effect (confirmation letter) has been received by the guarantor. In an untypical situation (the contract bond is issued before the counter-guarantee has been assumed) they may be modified as considered appropriate. This also applies in cases where a counter-guarantee is granted subsequently. The deadline of 20 bank days for payment of the pro rata bond premium only begins here from the date on which the confirmation letter is received by the guarantor.

4. THE FEDERAL GOVERNMENT'S LIABILITY UNDER THE COUNTER-GUARANTEE

The Federal Government's liability must be distinguished from the effectiveness of the counter-guarantee. If, under normal circumstances, the contract bond has not yet been issued when the confirmation letter is received, the former begins when the contract bond is issued, and thus is identical with the beginning of the objective risk for the guarantor. This means that the commitment exists prior to the effectiveness of the counter-guarantee as described under the preconditions for effectiveness listed above. Thus, if the bond is called before the counter-guarantee becomes effective, this crystallization of the risk is already formally a legal reality, and creates the claim for reimbursement which the guarantor has against the Federal Government as soon as the counter-guarantee becomes effective. If, on the other hand, the counter-guarantee fails to become effective as a result of dilatory non-payment, the commitment which had begun up to that point becomes void. In respect of contract bonds which have already been issued when the confirmation letter is received, liability begins not until the date on which such letter is received with the consequence that any bond call made prior to that date would not be covered.

Up to the point at which the contract bond is issued, the Federal Government is entitled to exclude contract bonds from the counter-guarantee as a result of the occurrence of circumstances which increase the risk. The reference date here is that of receipt of the declaration to this effect. Contract bonds issued prior to this date are no longer covered by the declaration. From the objective commencement of the risk onwards, the guarantor is therefore protected from unilateral "revocations" of cover by the Federal Government.



5. EXPIRY OF THE COUNTER-GUARANTEE

There are three cases in which the counter-guarantee expires:

- ▶ When follow-on premium payments are not made on the date agreed.
- ▶ When changes to the contract bond are made subsequent to issuance at the instigation of the exporter as the principal of the bond which increase the risk by either expanding the scope of the bond or prolonging its validity, without first obtaining the consent of the Federal Government. This rule does not apply to the following: material risk-increasing factors which the Federal Government could have recognized on the merits of the case and the amount involved as being inherent in the conditions of the bond when it assumed the counter-guarantee and unilateral demands by the beneficiary for extension of the bond (“extend or pay” demands).
- ▶ When the guarantor’s liability under the contract bond ends.

6. THE FEDERAL GOVERNMENT’S PARTICIPATION IN COSTS INCURRED BY THE GUARANTOR

The Federal Government’s obligation is on principle confined to the reimbursement of the agreed percentage of the amount paid under the bond call. Costs incurred by the guarantor in issuing the bond are covered by the fronting fee which the guarantor is entitled to retain from the bond premium. The Federal Government will only bear a proportion of the costs incurred in procuring a defence against an unfair call on the guarantor under the contract bond which creates a claim for compensation for the guarantor based on his contract with the exporter.

7. THE GUARANTOR’S FORMAL UNDERTAKING UNDER THE COUNTER-GUARANTEE

Submitting a Letter of Undertaking – Counter-guarantee within the period stipulated is one of the four preconditions for the counter-guarantee becoming effective. The cardinal obligations accruing for the guarantor from this have been described above. In addition, this Letter of Undertaking regulates:

- ▶ The guarantor’s (own) commitment to pay the Federal Government’s share in subsequent bond premium payments as long as the counter-guarantee is effective
- ▶ The percentage due to the Federal Government of the proceeds of realization of any security interests which the guarantor – solely in respect of the individual bond in question – has taken from the exporter
- ▶ The necessity of obtaining the Government’s prior consent when any rights out of the counter-guarantee are assigned
- ▶ An undertaking by the guarantor not to take recourse on the exporter to the extent that he has a claim on the Federal Government for reimbursement. In addition, there must be an agreement between the guarantor and the exporter that the claim for compensation expires as soon as the guarantor has been finally reimbursed by the Federal Government. The reason for this is that the exporter should not be exposed to overlapping claims from two directions when the bond is called, a situation which could occur since the Federal Government, in addition to the guarantor’s claim for compensation, also has its own recourse claim on the exporter. The claim for compensation must, however, remain valid as far as this is necessary for the realization of any security interests.

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V. THE LEGAL RELATIONSHIP BETWEEN THE FEDERAL GOVERNMENT AND THE POLICYHOLDER (EXPORTER)

1. THE FEDERAL GOVERNMENT'S CLAIM FOR RECOURSE ON THE EXPORTER

The hallmark of the legal relationship between the Federal Government and the policyholder under the counter-guarantee is the former's claim for recourse against the exporter. This corresponds in practice to the guarantor's claim on the exporter for compensation on calling of the bond. It is legally substantiated when the Federal Government reimburses the guarantor, and in the amount actually reimbursed. That said, it is only payable immediately in certain well-defined cases. Otherwise it is normally deferred for a period of six months – reckoned from the payment made by the Federal Government to the guarantor. This deferral is made on condition that the policyholder (the exporter) submits an abstract statement on a specially prepared form according to § 781 of the German Civil Code recognizing the validity of the recourse claim.

The deferral of the claim granted on the strength of this abstract statement is intended to give the policyholder time to gather evidence to support a claim for indemnification under the parallel contract bond cover he has. If this claim is successfully documented before the deferral period has expired, the two claims are set off against each other. There is therefore no possibility of a deferral if it is clear from the outset that indemnification under the contract bond cover is completely excluded or if at least a certain percentage of a position under the contract bond cover which has been reimbursed pro rata by the Federal Government is not indemnifiable. These cases in which recourse is to be taken immediately are the following, as set out in the policy with the exporter:

- When either the policyholder himself or another party files a petition for insolvency in respect of the policyholder's assets or insolvency proceedings are opened or insolvency proceedings are rejected for lack of assets or when it is accepted without dispute that the contract bond which is the object of the policy has been fairly called for commercial reasons or
- The exporter has not used all due and reasonable care in his business dealings to prevent the calling of the bond or
- The exporter has obtained the counter-guarantee by giving incorrect and/or incomplete information or
- The Federal Government has been obliged to reimburse interest and/or costs to the guarantor under the counter-guarantee in connection with the procuring of defences against an unfair call (the immediate recourse is to this extent only in respect of these items).

In order to ensure the option of setting off the recourse claim and the exporter's claim for indemnification where appropriate, the Government's recourse claim becomes effective under all circumstances the moment the indemnification on the other side is payable. Since the maximum percentage assumed by the Federal Government under a counter-guarantee, 80%, will always be lower than the insured percentage of 95% under contract bond cover, this means that on principle the exporter (the policyholder) will receive an excess payment when he is indemnified.

If the exporter is unable to provide evidence of a valid claim under the contract bond guarantee within the deferral period, or if the conditions listed above under the first three bullet points for the immediate effectiveness of the recourse claim occur within this period, recourse will be taken, where necessary relying on the



abstract statement recognizing the validity of the claim. This claim must be immediately satisfied upon presentation to the exporter. All pleas and defences against it are excluded, including any setoff, and, where appropriate, are relegated to a later legal action. The recourse claim additionally includes any interest accrued on the amount paid to the guarantor. The Federal Government's normal refinancing rate is applicable here.

If immediate recourse has been taken on the exporter by the Federal Government, either within the deferral period or subsequent to it, the contract bond cover remains unaffected. If the exporter succeeds in later documenting that a valid claim for indemnification exists, indemnification will be paid in full subject to the valid self-retention of 5 %.

2. MODIFICATIONS TO THE CONTRACT BOND GUARANTEE IN THE CASE OF ADVANCE PAYMENT BONDS

It was pointed out above that the usual type of cover available to insure risks arising under advance payment bonds (no direct cover by means of a contract bond guarantee, but cover for prime costs within manufacturing risk cover) is not possible when a counter-guarantee is assumed. A counter-guarantee is only possible together with a parallel contract bond guarantee.

In order to provide a solution on the same conditions as under the direct cover for an advance payment bond which is now necessary, manufacturing risk cover must be taken out in addition to the contract bond guarantee. The loss of the sum paid in advance for any reason other than calling of the bond is then covered under the manufacturing risk policy, while losses due to calling are in any case and primarily insured under the contract bond guarantee. In order not to pay double premium by

having two parallel forms of cover for same amount at risk, the premium for contract bond cover is included in that for the manufacturing risk cover when both are taken out together. The automatic limitation of any indemnification to the amount of the prime costs which applied under the usual cover is here ensured by adding a special documented clause to the contract bond guarantee. This maximum indemnification clause is necessary in the event that the indemnifiable prime costs are lower than the amount paid under the bond call, since the exporter's indemnification (the amount of the advance payment bond) would otherwise be higher than his actual loss (the prime costs not covered by the advance payment).

When an exporter considers his cover under a contract bond guarantee to be sufficient for his needs, he has the alternative of either not taking out manufacturing risk cover at all or doing so, but after deducting the amount of the advance payment from the prime costs to be covered. In this case it should be remembered that the loss of the bond amount is then only covered when the bond is called. On the other hand, he only has to pay the premium for the contract bond guarantee when insuring the amount of the advance payment. Under a manufacturing risk claim, the advance payment would always be deducted from the prime costs which have accrued. The limitation of the amount to be indemnified mentioned above would also apply here.

Dr. Roland Scheibe

Cover from the Federal Republic of Germany for business transactions abroad

The German Government supports German business ventures abroad with its Export Credit and Investment Guarantee Schemes as well as the Untied Loan Guarantee Scheme, thus securing economic growth and safeguarding jobs. To this end, the Federal Republic of Germany provides guarantees against commercial and political risks in connection with export transactions as well as against the political risks of foreign direct investments. In addition to this framework, it is also possible to cover the commercial and the political risks of untied loans relating to projects which are in the overriding national interests of Germany.

The German Government has mandated a consortium formed by Euler Hermes Kreditversicherungs-AG and PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft to manage these promotion schemes.



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